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Federal Communications Commission
Office of Secretary

EX PARTE

William F. Caton
Acting Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Dear Mr. Caton:

Re: CC Docket No. 96-45, Universal Service

Today, John Gueldner, Ronnie Thierman, Mary Vanderpan, and Rex Mitchell, all of Pacific Bell, spoke by telephone with Commissioner Laska Shoenfelder of the Joint Board to discuss the attached document in reference to the above docket. Please associate this material with the above referenced proceeding.

We are submitting two copies of this notice in accordance with Section 1.1206(a)(1) of the Commission's Rules.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,

Alan Ciamporcero

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List A B C D E

Competition, Interconnection and the Universal Service Imperative

Presented by Pacific Bell

October 1996

Key Elements of a Universal Service Subsidy Solution

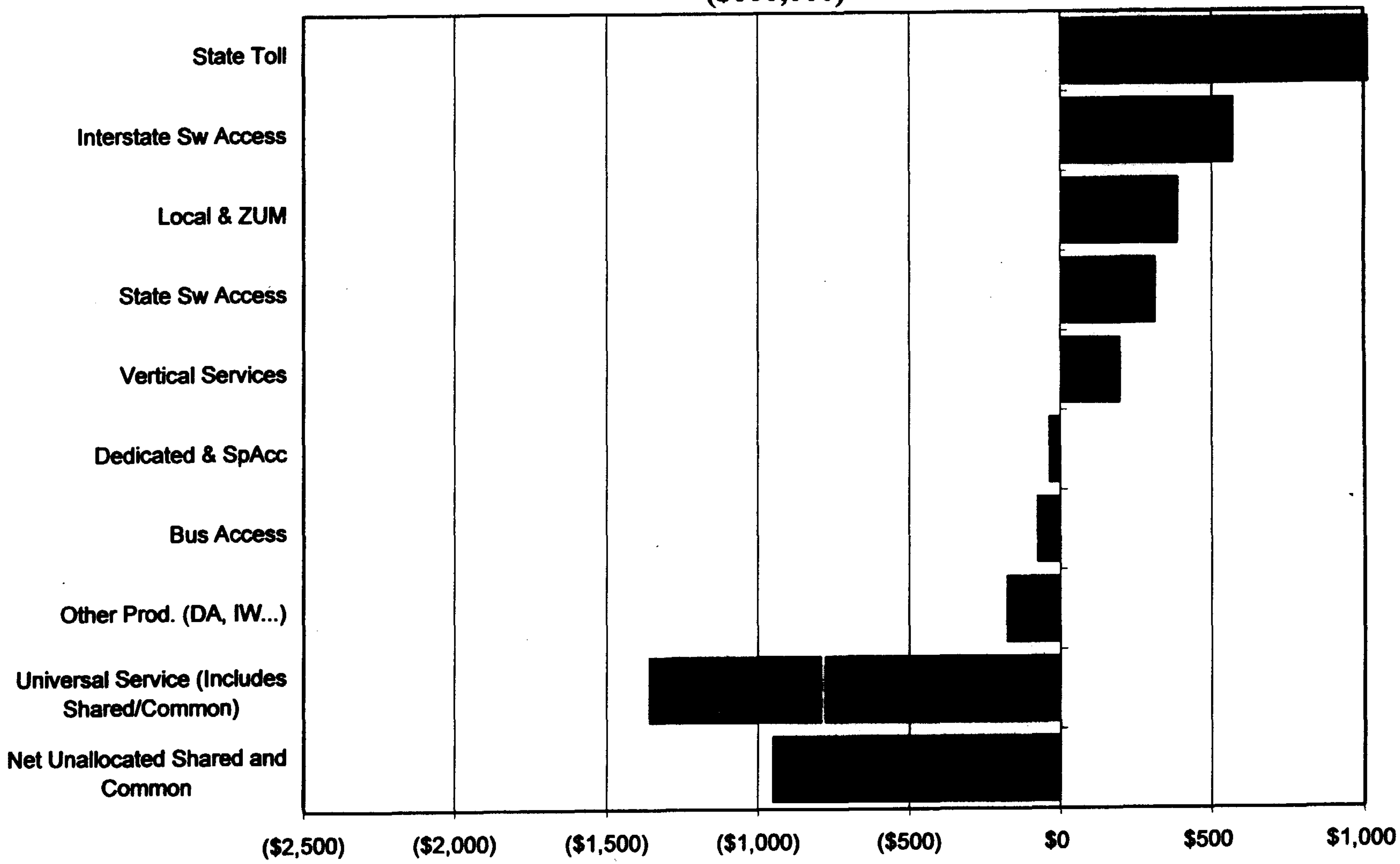
- Sizing a new Universal Service Fund
- Determining the scope of the geographic area to be targeted
- Setting a benchmark price
- Linking subsidy to an unbundled, resale environment
- Addressing jurisdictional issues
- Focusing on the needs of the educational community

Existing Subsidies Found Within Pacific Bell's Current Prices are Both Product to Product and Geography to Geography

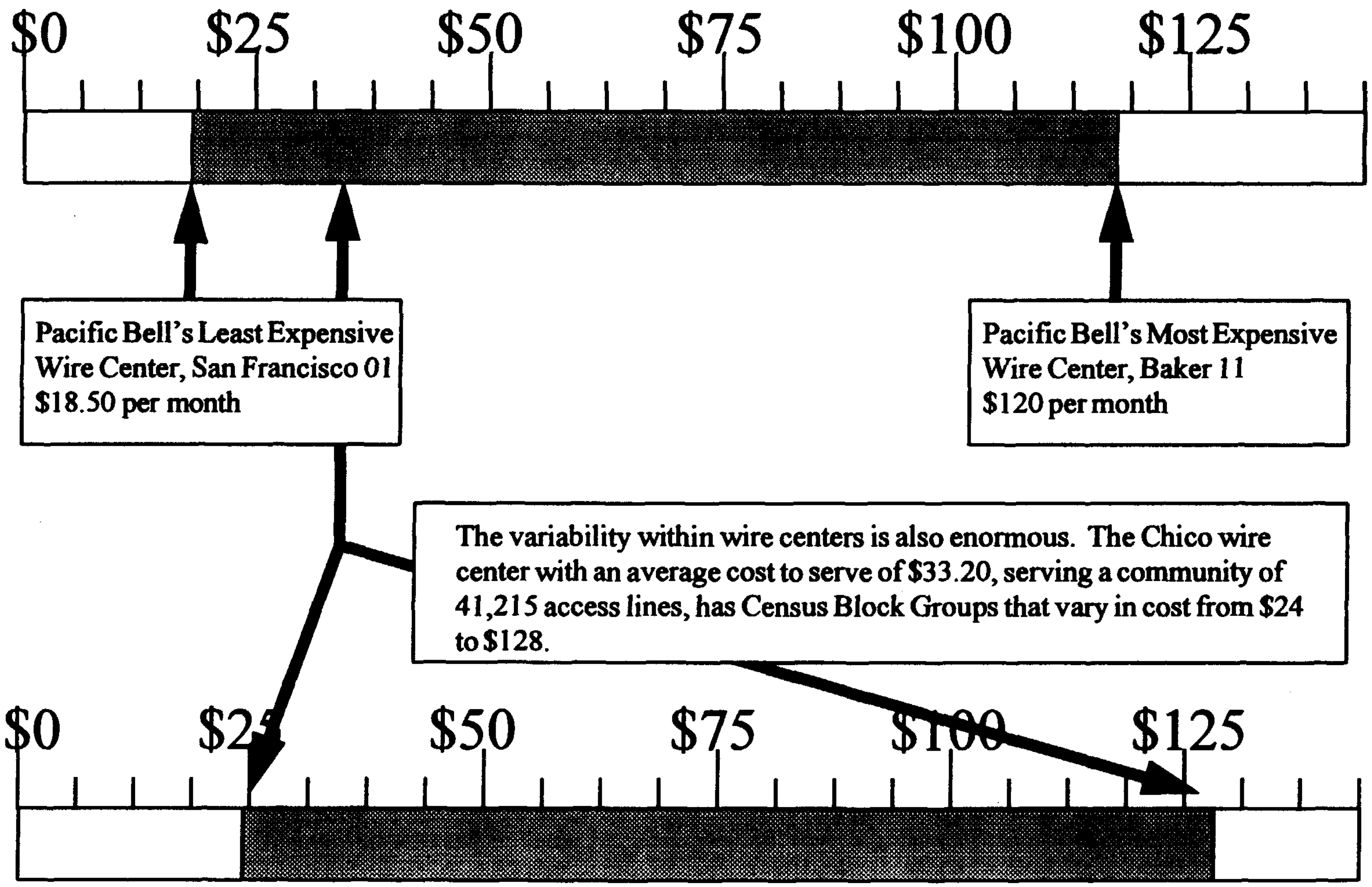
- The product to product subsidies are generally usage to residential basic exchange -- Universal Service
- Geographic subsidies are generally urban to rural

Pacific Bell - 1995 Product to Product Subsidy

($000,000)

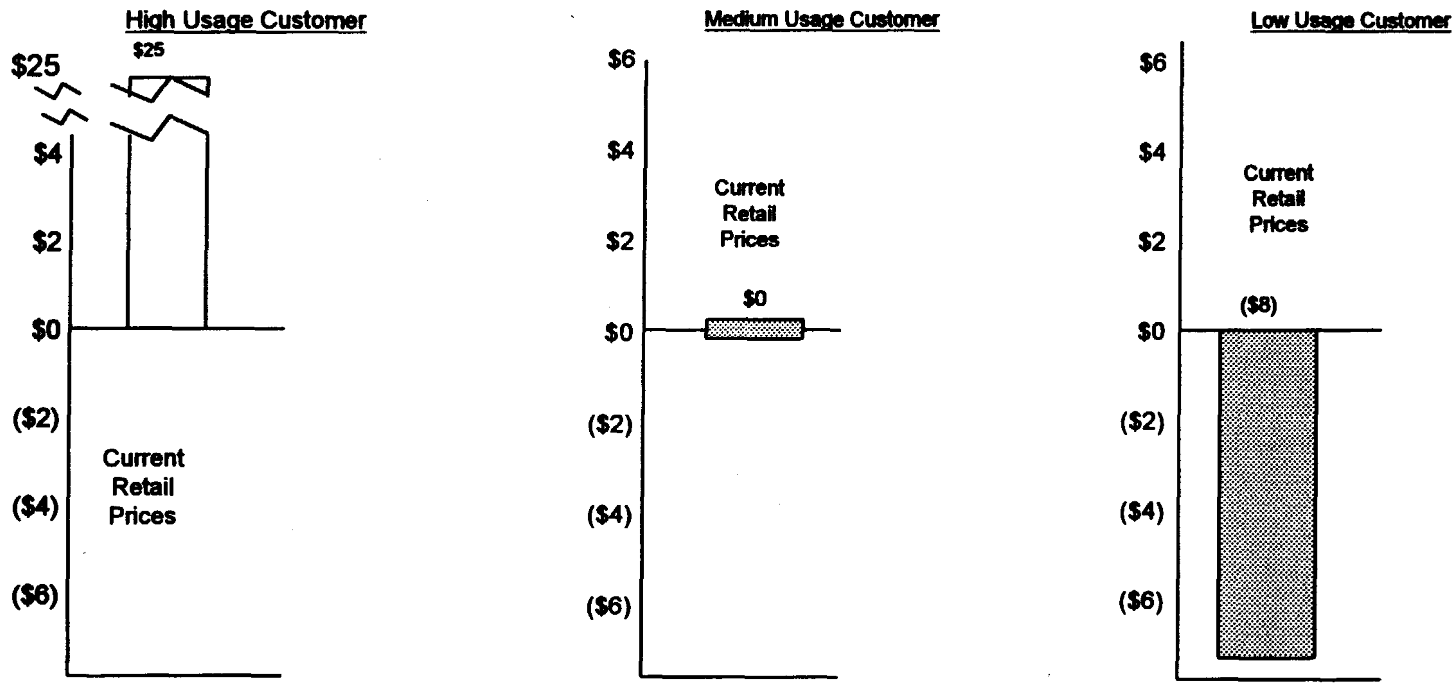


There is Extreme Variation in the Cost of Basic Exchange Service Which Must be Recognized in any Universal Service Solution



The Implicit Subsidies Within Pacific Bell's Pricing Structure Presents a Very Significant Cream Skimming Opportunity

Pacific Bell Margin per month for one residential line



The margin is calculated by combining all products and services purchased directly or indirectly by the customers within each usage category

Implications of FCC Interconnection Order on Universal Service and Access Reform

- **Order makes universal service and access reform an immediate imperative**
  - Results in loss of implicit and explicit subsidies that now support universal service
    - *Turns the $1.3 billion subsidy in Pacific's prices today into pure profit opportunity for the CLCs,* ***but the subsidy need does not disappear***
    - *Destroys access charge structure as we know it today, and explicit support for universal service,* ***but the subsidy need does not disappear***

The Order Creates Significant Profit Opportunity for CLECs in California at the Expense of Universal Service

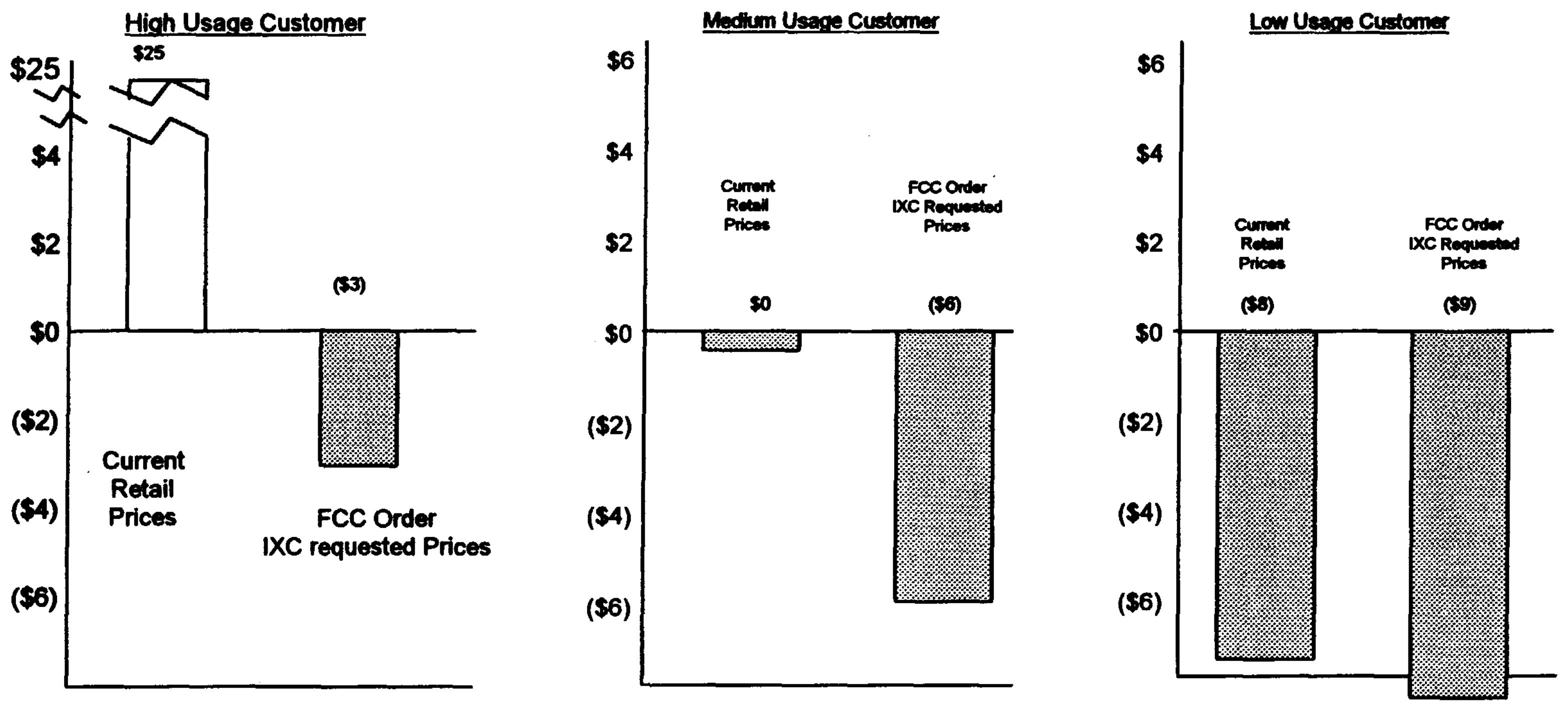
- CLECs can profitably serve all of our customers by choosing to buy unbundled elements (at cost-based prices) or resale services (at discounts off of our retail prices -- even prices that are currently subsidized)
- For the CLECs, every customer is a winner
  - High usage customers
    - Buy unbundled links and use own switch
    - Take full advantage of the subsidy currently contributed by these customers
  - Average usage customers
    - Buy unbundled links and LEC's switch (e.g., rebundling)
    - Take full advantage of the subsidy currently contributed by these customers
  - Low usage customers
    - Buy LEC's resale services
    - Leave the subsidy requirement with the LEC
- There is no reduction in the existing subsidies needed while there is a loss of existing subsidy support

Impact on Pacific Bell Earnings in the Consumer Market

Result: Pacific loses contribution for every line sold to CLECs

- Cream-skimming heightens the effect of share loss in the consumer market

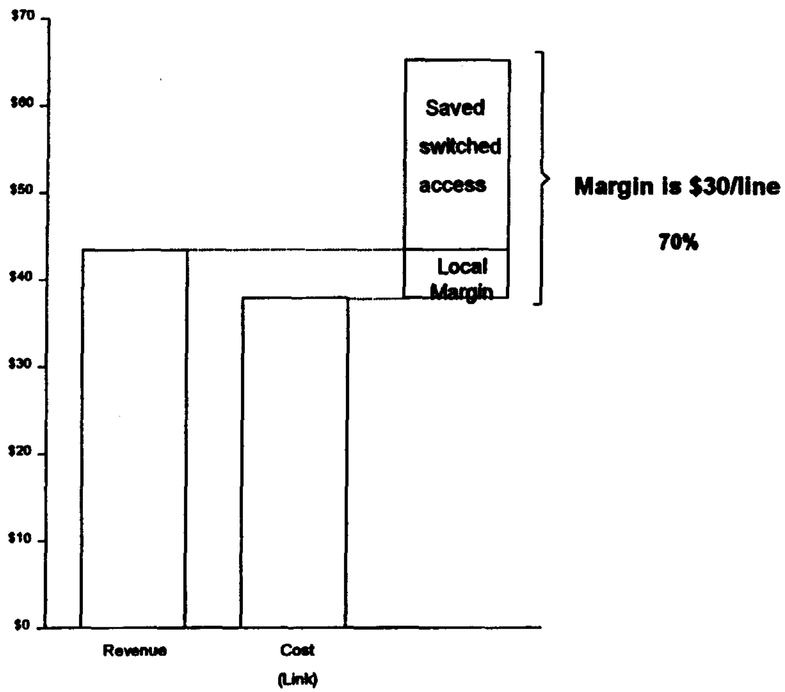
Pacific Bell Margin per month for one line

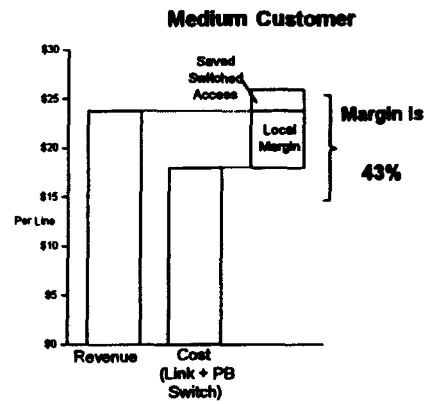


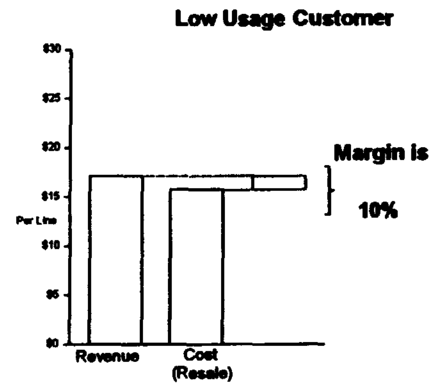
Because of tremendous incentives for CLECs to attack high usage customers,
Pacific will lose the customers who provide margins to pay for Universal Service.
The CLECs may retain positive margins because they may provide minimal support of Universal Service.

CLECs Can Profitably Serve All Customer Segments Through Unbundled Elements, Rebundling and Resale

- CLEC margin (per line per month) is positive even for low usage residence lines which are unprofitable for Pacific Bell





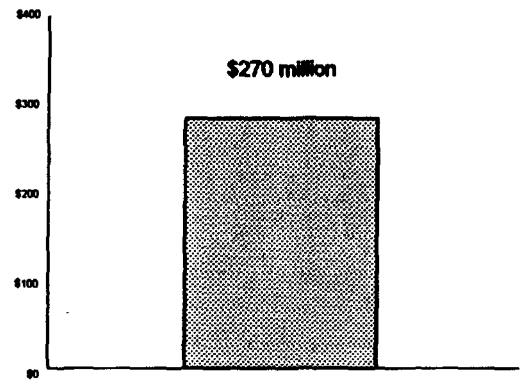


Large IXC's proposed prices are used for this illustration.

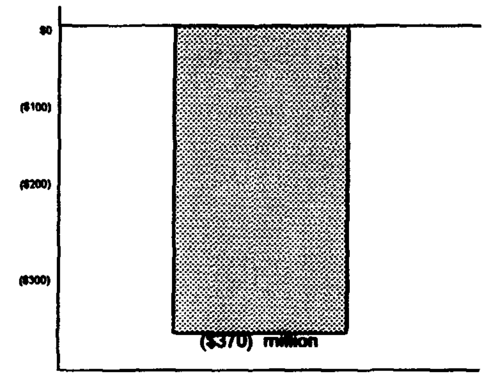
The Interconnection Order Enables IXCs to INCREASE Profits While Dramatically Reducing Pacific Bell's Profits

- Pacific will implement prices and terms which meet the FCC Order requirements even though Pacific has filed an appeal of that Order

Estimated AT&T Pre-Tax Annual Margin from Residence Local Services in Calif. with 96-98 Order

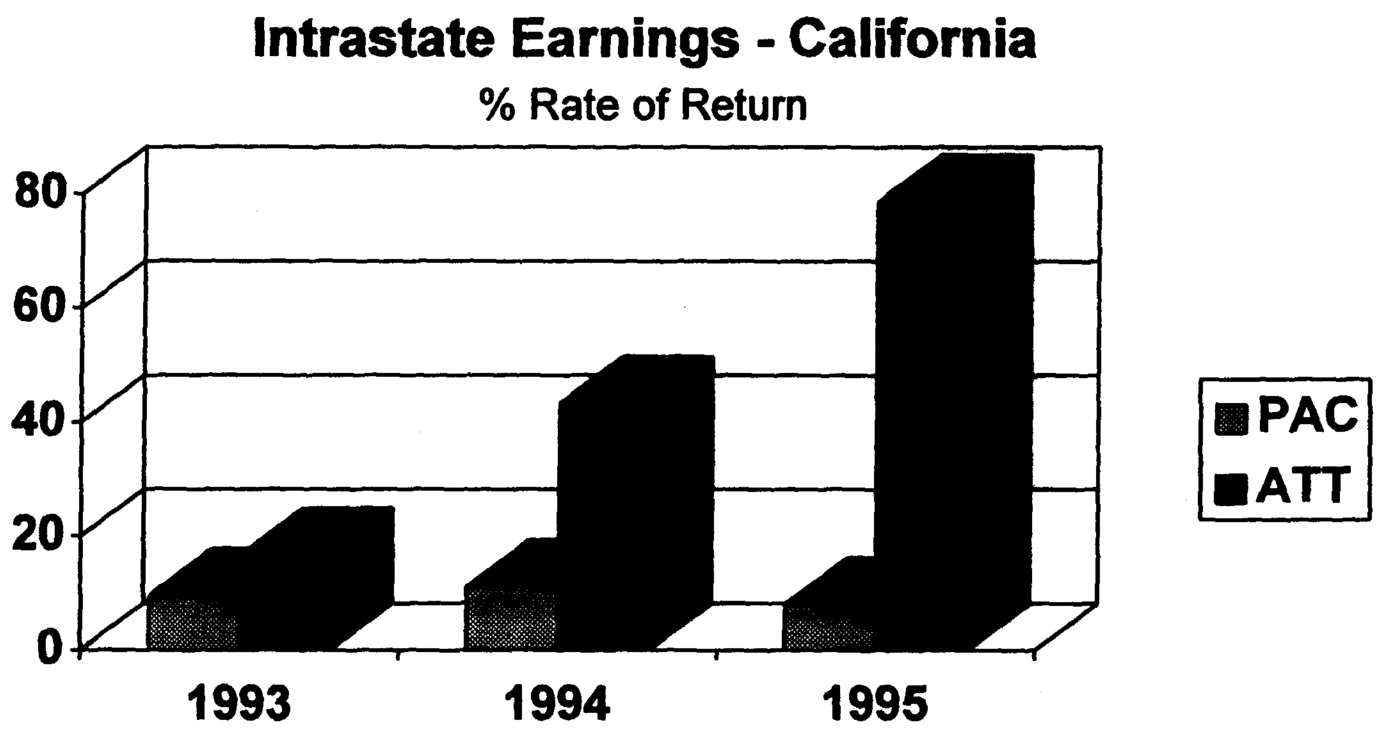


Pacific Bell Annual Loss of Pre-Tax Earnings due to Local Competition in Residence Market Only



AT&T's proposed prices are used for this illustration.
Annual estimates by end of 1998 w/o switched access restructure impact.

The IXCs Do Not Need Financial Assistance From Regulators



- Pacific's reductions in switched access prices have dramatically increased AT&T's earnings
- To date, IXCs have not shown a propensity to flow through LEC price reductions to their customers

Universal Service Subsidy Must Be Appropriately Sized

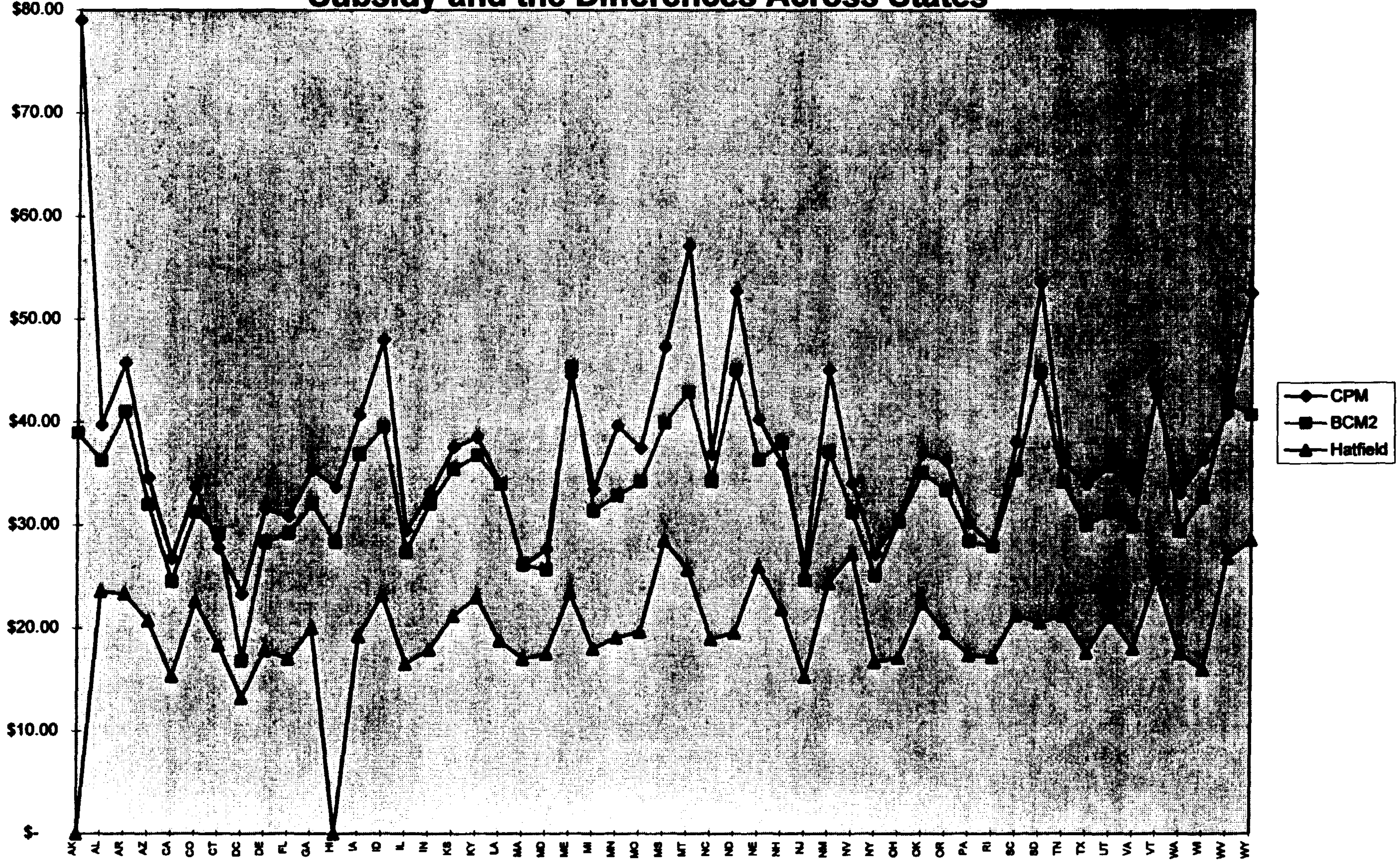
- **The Telecommunications Act of 1996 requires a "specific, predictable and sufficient" mechanism to fund subsidy**
  - An undersized fund will not eliminate subsidies implicit in current prices; the market will thereafter eliminate the subsidies through a combination of resale and rebundling -- subsidies would not be available to universal service
  - An undersized fund will discourage investment -- companies will not invest in facilities if they cannot expect to realize a profit from them

	Assume Hatfield is Correct	**Assume CPM is Correct**
Hatfield Prevails	**OK**	• Under investment • Intense resale and rebundling competition • Hundreds of businesses spring up -- all dependent on arbitrage • Difficult to increase prices later (e.g., ESP exemption)
CPM Prevails	• Over investment • Intense facilities based competition • Competition develops more slowly • Easy to lower prices later	**OK**

Universal Service Subsidy Must Be Appropriately Targeted

- Current system targets study area (state)
  - By averaging across a large geographic area, carriers who serve states with mix of high cost and low cost areas are penalized
- Subsidy dollars must be narrowly targeted to prevent cream-skimming
  - Subsidy support should be determined on the basis of the smallest practical geographic unit (e.g., census block group)

The Cost Proxy Model and BCM2 Track Closely in the Amount of Subsidy and the Differences Across States



A Benchmark Price

- FCC must set just, reasonable and <u>affordable</u> rates
- Affordability must be targeted below the state level so that low income areas are not penalized for being in the same state with high income areas
- A national or statewide benchmark obscures the wide variation in rates and income levels
- Target benchmark to county income level
  - A <u>county</u> median income benchmark (0.7%) addresses the income disparities between urban and rural

State	Low Income County	High Income County
California	$20,500	$48,000
Missouri	$13,800	$40,300
Washington	$20,000	$36,100
Florida	$15,400	$35,600
South Dakota	$13,300	$28,500

Subsidy in an Unbundled, Resale Environment

- Subsidy dollars must flow to the entity incurring the cost but not recovering it
- For resale, subsidy must go to facilities based provider -- by definition, if retail price requires subsidy, discounted wholesale price requires the same subsidy
- For unbundled elements, subsidy must be apportioned between the facilities provider and the retail provider
  - The apportionment must take into account that unbundled element prices are geographically deaveraged into a small number of zones while universal service support must be targeted into smaller areas (e.g., census block group)
  - Apportionment can be accomplished through an appropriate model that disaggregates costs for link, switch, etc. on a geographic basis

Universal Service - Jurisdictional Issues

- FCC interconnection and pricing rules affect both jurisdictions
- Congress intended universal service provisions, whether established by state and/or federal regulators, to yield "just, reasonable and affordable" rates
- Jurisdictional split should be based upon a benchmark, not separations rules
  - Benchmark approach complies with the Act
  - FCC would fund costs above the benchmark
  - States can establish subsidy funding for the difference between the federal benchmark and the basic service price (if price is below the benchmark)
- Subsidy should be funded by a surcharge across all telecommunications services
  - States would apply a surcharge across all telecommunications services originating in the state
  - The FCC would apply a surcharge across all telecommunications services

Education Proposal

- Distribute funds directly to schools and libraries via credits. Providers redeem credits for cash from the fund.
- Allocate funds according to:
  - Threshold for all institutions
  - Incremental support based upon number of students
  - High cost, low income, technological impoverishment variables
- Carry annual allocations over year-to-year so institutions who are not ready do not lose support

Actions for
Universal Service Joint Board

- Establish a fund large enough to address the impact of Interconnection decision
- Establish reasonable benchmark. Target benchmark to relatively small area (county).
- Determine costs above benchmark using either actual costs or accurate proxy model
- Distribute subsidy based on small geographic unit (census block group at the minimum) to avoid cream-skimming